Joint Economic Committee
WEEKLY ECONOMIC DIGEST

Senator Charles Schumer, Chairman
Congresswoman Carolyn Maloney, Vice Chair

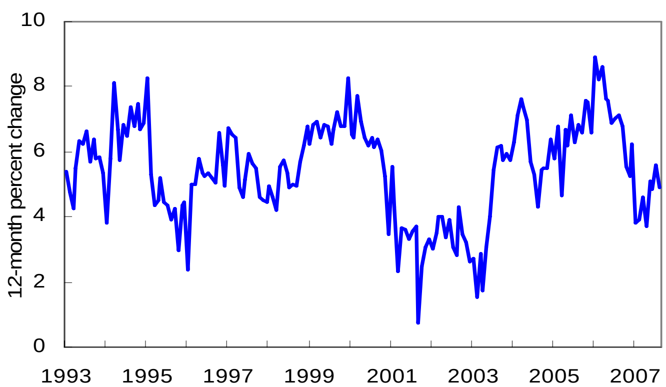
September 17, 2007

ECONOMIC NEWS

Slower-Paced Sales Sharpen Growth Concerns

Retail sales decelerated in August. Sales at retail establishments and food services grew by 0.3 percent last month, following a 0.5 percent rise in July. The August increase reflected a rebound of 2.8 percent in sales of motor vehicles and parts, following a 0.3 percent drop in July. Retail gasoline sales declined by 2.4 percent while sales of building materials and related goods dropped by 1.0 percent. Excluding the volatile automotive categories, retail sales dropped by 0.4 percent last month, and have risen at a modest 4.9 percent pace over the past 12 months (see chart).

Retail Sales Excluding Motor Vehicle and Gasoline Sales



Source: Bureau of Labor Statistics, U.S. Department of Labor.

Growth of industrial production slowed last month as factory output dropped. Total production in manufacturing, mining, and utilities increased by 0.2 percent in August, after rising by 0.5 percent in July. The output of utilities rose by 5.3 percent in August, as much of the country experienced heat waves last month. However, factory output dropped 0.3 percent last month and declines pervaded the production of durable and nondurable goods. Over the past 12 months, overall factory output has risen by only 1.7 percent.

The current account deficit narrowed slightly in the second quarter. The U.S. current account balance, which combines the balance on trade in goods and services with the balance on international income flows and transfers declined by $6.3 billion to $190.8 billion in the second quarter. That improvement mainly reflected a decrease in U.S. government grants to foreigners. Even so, the current account deficit remains at an unsustainable 5.5 percent of gross domestic product.

IN FOCUS

Subprime Uncertainties Cloud the Outlook

Last week, Treasury Secretary Paulson warned that the current turmoil in the credit markets was likely to persist longer than was the case for the financial shocks of the last two decades. He attributed the likelihood of a protracted credit market adjustment to the problem of valuing assets related to mortgage-backed securities, and the dispersion of those assets across global financial markets.

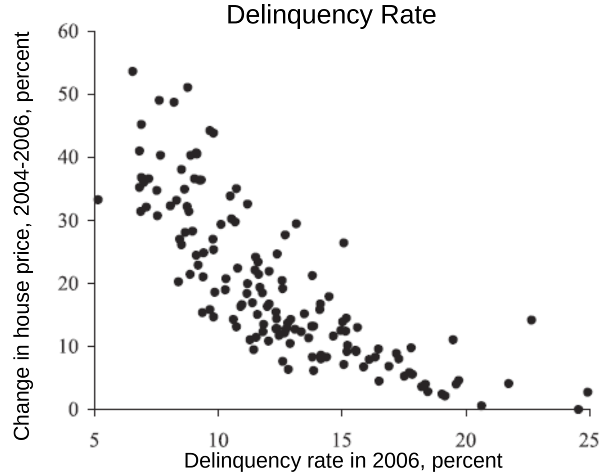
We do know some things about the subprime situation as it currently stands. First, subprime mortgages increased in number and dollar volume in the last 6 years, as did the share of "riskier" adjustable rate mortgages (ARMs). Those riskier ARMs include "zero-interest" mortgages and negative-amortization loans which have been issued at an accelerated pace in recent years. Second, foreclosure rates on subprime loans have increased recently, from 3.3 percent in the middle of 2005 to 5.5 percent in the second quarter of 2007, according to data from the Mortgage Bankers Association. Among those subprimes, ARM foreclosures increased from 3.2 to over 8 percent over the same period. Moreover, delinquency rates on subprime loans have risen from 10.3 percent in mid-2005, to 14.8 percent last quarter. Delinquency rates on subprime ARMs have increased from 10.0 percent to 17.0 percent over the same period.

Unfortunately, delinquencies and foreclosures in the sub-

Continued on reverse...

SNAPSHOT

Changes in House Prices and the Subprime Delinquency Rate



Sources: First American LoanPerformance and Office of Federal Housing Enterprise Oversight.
Note: Data points represent Metropolitan Statistical Areas.

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THE WEEK AHEAD

DAY	RELEASE
Monday, Sep 17	Flow of Funds Accounts of the United States (Second Quarter 2007)
Tuesday , Sep 18	Producer Price Index (August 2007) Federal Open Market Committee statement on monetary policy
Wednesday, Sep 19	Consumer Price Index (August 2007) New Residential Construction (August 2007) JEC Hearing: *"Evolution of an Economic Crisis? The Subprime Lending Disaster and the Threat to the Broader Economy*, 216 Hart Senate Office Building at 9:30am

Tuesday, Sep 18th: Will the Fed cut its short-term interest rate target? By how much?

THE ECONOMY AT A GLANCE

KEY INDICATORS	MONTH			QUARTER			YEAR	
	Aug	Jul	Jun	2007 Q2	2007 Q1	2006 Q4	2006	2005
Real GDP Growth (%)	—	—	—	4.0	0.6	2.1	2.9	3.1
Unemployment (% of labor force)	4.6	4.6	4.5	4.5	4.5	4.5	4.6	5.1
Labor Productivity Growth (%)	—	—	—	2.6	0.7	1.8	1.0	1.9
Labor Compensation Growth (%)	—	—	—	3.6	3.2	3.6	3.1	3.3
CPI-U Inflation (%)	n.a.	1.2	2.4	6.0	3.8	-2.1	3.2	3.4
Core CPI-U Inflation (%)	n.a.	2.4	2.4	1.9	2.3	1.9	2.5	2.2

Sources: Bureau of Economic Analysis, U.S. Department of Commerce; Bureau of Labor Statistics, Department of Labor.

Notes: Except where otherwise noted, values in the table represent percent changes at seasonally adjusted annual rates. Productivity is output per hour worked in private nonfarm businesses. The Employment Cost Index is for civilian workers in government and business. Core CPI-U inflation is the percent change in the CPI-U excluding food and energy as reported by the Bureau of Labor Statistics. The designation "n.a." denotes that data are not yet available.

IN FOCUS (Continued)

prime market will probably increase in the coming months. Subprime lending proliferated while the overall housing market was experiencing record increases in home prices. Since then, however, housing prices appear to have stopped rising, on average. Indeed, some measures of home prices have already declined, by more than 3 percent since the beginning of 2007. Some economists, including Nouriel Roubini and Robert Shiller, are predicting that real (adjusted for general inflation) housing prices are likely to decline by more than 15 percent over the next two years.

Declines in home prices would likely escalate foreclosure rates for subprime as well as less-risky mortgages. While home prices were rising, appreciation worked to mask the vulnerabilities of risky home loans. Many borrowers were able to refinance their original loans once the low initial rates started to increase. Now that house prices have stopped rising, more borrowers could end up holding negative equity in their homes. When borrowers encounter difficulties making their mortgage payments, their lack of home equity might make it impossible for them to sell or refinance their homes. For example, economists at the Federal Reserve Bank of San Francisco recently found those metropolitan statistical areas (MSAs) that experienced relatively low rates of home price appreciation over the course of 2004 through 2006 tended to also experience relatively high delinquency rates on subprime loans in 2006 (see SNAPSHOT).

Moreover, increased foreclosures on vulnerable homes can have adverse effects on the values of neighboring properties. For example, recent research has indicated that prices of nearby homes could fall by 1 to 1½ percent for each foreclosed home in a particular neighborhood (see D. Immergluck and G. Smith, "The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values," *Housing Policy Debate*, 17(1), 2006, pp. 57-79).

Clearly, a continuation of the subprime failures could well engender a wider range of adverse results. The JEC will investigate some of the repercussions of the subprime fallout on financial markets and the economy at its hearing on Wednesday.